



## TRADITION CAPITAL MANAGEMENT, LLC

[www.traditioncm.com](http://www.traditioncm.com)

THE SEPARATE MANAGED ACCOUNT (SMA) industry has nearly \$1 trillion in assets, with nearly half being taxable assets. The value proposition for SMAs has always been tax-management customization, but in reality, the majority of SMAs are still receiving little or no customized tax treatment. Taxes are the most significant single expense for investors and are often overlooked. In addition to fees, taxes should be viewed as a price to pay for active portfolio management. Unfortunately, it is a phantom price not quantified on quarterly client statements. A recent study published by Lipper, a mutual fund research company, concluded that mutual fund investors give up between 1.3% and 2.5% of return per year in income taxes, or about 23% of their total returns. A well-crafted strategy can avoid most of this negative tax hit and thus improve net bottom-line performance. Over decades, the additional basis points can amount to substantial wealth.

## **Firm History**

Tradition Capital Management, LLC. was founded in 2000 by Benjamin Halliburton, CFA, Chief Investment Officer, Christopher Trompeter, CFA, Senior Portfolio Manager, and later joined by Michael Provine, J.D., LL.M, Portfolio Manager. Tradition Capital Management is an independent investment organization that is privately owned by its employees and is exclusively focused on providing the highest quality separate account investment management services with honesty and integrity. Prior to founding the firm, Ben, Mike and Chris worked together for several years servicing and managing high-net-worth (HNW) clients at a prominent New York based money manager. Tradition was formed by replicating the best aspects of portfolio management, investment research, and client service. We are consistent in our investment approach allowing our clients to build a legacy of after-tax wealth.

## **Investment Philosophy**

At Tradition Capital Management, we adhere to the time-tested notion that wealth is best created and preserved through diligent, long-term participation in the equity markets. We seek high-quality companies with competitive advantages that are positioned to experience strong relative earnings growth. We look at companies across all levels of market capitalization and purchase them when they are selling at a “margin of safety,” an initial 20% discount to our estimate of fair value. Since we focus on investing versus trading, our capital gains are most often long-term, which receive preferable tax treatment for high-net-worth clients. Our objective is not to avoid paying taxes but to maximize returns while making smart judgments relating to the timing of trades, capturing losses, and portfolio construction.

## Our Distinction

Unlike enhanced index funds, Tradition takes an active bottom-up approach to building a portfolio. It is an integrated process designed specifically for taxable HNW investors. We seek high-quality investments across the market capitalization spectrum and select stocks that are categorized as both value and growth. While Tradition's investment process is structured and disciplined, it does allow us to be nimble. This flexibility allows our clients to hold a diversified risk-averse portfolio while exploiting inefficiencies in the marketplace regardless of capitalization or style box. While the traditional style box investing makes sense for nontaxable institutional investors with unlimited time frames, it is not the optimal approach for taxable HNW clients as this style box construction creates unnecessary tax drags on two fronts: capital reallocation between managers and secondly, individual manager trades in order to maintain style box purity.

The following chapters are excerpts from the Bloomberg Press book *Tax-Aware Investment Management* by Douglas S. Rogers, CFA. Mr. Rogers does an excellent job in explaining why our industry needs to think differently in allocating HNW and the traits of an effective tax-aware equity manager.

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Prior to joining Laird Norton Tyee, Mr. Rogers served within the consulting industry as a chief investment officer and director of traditional manager research, where he has implemented tax-aware strategy and created open-architecture manager platforms to serve high-net-worth families. He has also worked with property and casualty insurance companies, nuclear decommissioning trusts, and medical retirement accounts.

Mr. Rogers understands the taxable-account industry from multiple perspectives, including investment policy, asset allocation, manager search activity, portfolio management, security analysis, and reporting. He is the chairman of the AIMR Subcommittee for After-Tax Performance Reporting, which was responsible for interacting with the Securities and Exchange Commission on the after-tax standards for mutual funds and made recommendations to revise the existing separate account standards to their current form.

Mr. Rogers is a graduate of the United States Military Academy and holds an MBA from Southern Methodist University. A nationally recognized speaker and author, he is also a Chartered Financial Analyst. In 2001, he received the annual Peter Dietz Award for the most significant contribution to the body of knowledge in performance measurement, for his article "The Challenges of After-Tax Performance Reporting" in the spring 2000 issue of the *Journal of Performance Measurement*.

Author photograph by Robert Bahner Photography

**TAX-AWARE**  
**INVESTMENT MANAGEMENT**  
**THE ESSENTIAL GUIDE**

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**DOUGLAS S. ROGERS, CFA**

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CHAPTER EXCERPTS

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**Why the Style Box Hurts Taxable Investors**  
**Practices of Elite Tax-Aware Equity Active Managers**  
**Summary**

**BLOOMBERG PRESS**  
NEW YORK

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Booklet excerpted from the book  
*Tax-Aware Investment Management*  
by Douglas S. Rogers, CFA

ISBN 978-1-57660-180-8

Published by arrangement with Bloomberg Press,  
731 Lexington Avenue, New York, NY 10022

To order *Tax-Aware Investment Management*, go to the Bloomberg Press website, [www.bloomberg.com/books](http://www.bloomberg.com/books). Books are available for bulk purchase at special discount. Special editions or chapter reprint booklets can also be customized to specifications. For information, please e-mail Bloomberg Press at [press@bloomberg.com](mailto:press@bloomberg.com), Attention: Director of Special Markets.

**C O N T E N T S** from *Tax-Aware Investment Management*

NOTE: Highlighted items are the sections printed in this booklet.

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# Why the Style Box Hurts Taxable Investors

*Because of the income tax, a penny saved is more than a penny earned.*

—JEFFERY L. YABLON

The schematic that we investment professionals are introduced to during our formative years categorizes equity managers according to the average market capitalization of common stocks in the model portfolio and the style methodology employed to select them.<sup>1</sup> Employing multiple equity managers for taxable clients according to this process leads to nothing more than “overpriced entertainment,” as suggested by David Stein of Parametric Portfolio Associates.<sup>2</sup> Unfortunately, trading by portfolio managers to maintain capitalization and style purity leads to premature and unnecessary realization of capital gains. Additionally, when an excessive number of managers are employed, the managers tend to come in at the high end of their individual fee schedules rather than allowing access to sliding-scale volume discounts when just a few managers are utilized. For taxable accounts, when it comes to determining the optimal number of equity managers, the rule of thumb is “Less is better than more!”

Concrete guidelines for segmenting common stocks according to market capitalization do not exist; more precisely, they differ from provider to provider. The mean and median market capitalization can be quite different. For example, the S&P 500 stock index currently has a mean market capitalization of \$90 billion, as compared with a median of \$10 billion.

**FIGURE 1** *Traditional Equity Manager Style/Capitalization Grid*

	Value	Core	Growth
Large			
Middle			
Small			

Source: Douglas S. Rogers

The mean market capitalization in the Russell 1000, MidCap, and 2000 indices are \$80.2 billion, \$6.2 billion, and \$0.9 billion, respectively for the large-, middle-, and small-capitalization segments of the domestic stock market. These values can shift dramatically, depending on the average price-to-earnings ratio of stocks and investment banking activity.<sup>3</sup> Corporate transactions involving initial public offerings, companies going private, mergers, and takeovers influence the composition of the various market indices.

Attempting to categorize and benchmark managers according to their purchase and sale methodology can be challenging, as managers may employ eclectic approaches. Managers selecting stocks with a growth orientation typically seek companies with superior earnings growth and correspondingly high price-to-earnings (P/E) or price-to-book (P/B) ratios. On the other hand, value managers attempt to identify stocks that are trading at a discount to others and typically have a lower P/E or P/B multiple than the overall market. A “core” or a “blend” strategy simply combines elements of both the value and growth stock-selection methodologies.

**FIGURE 1** illustrates the traditional equity style/capitalization grid.

Over the years, the tax-exempt-account consulting industry has emphasized style/capitalization purity to create a high degree of focus and specialization, as there is an accepted belief this eliminates overlap and creates the most potential for superior returns. It is taken so seriously that managers are often terminated if they drift too far away from their per-

ceived category. While this may benefit tax-exempt account investors, it works to the detriment of the taxable investor.

The frictional costs to taxable investors come in three ways. The first cost associated with maintaining style purity is the cost of trading. The other two costs are far more significant and involve the payment of taxes on realized capital gains. This occurs when a security must be sold, because a change in price causes the P/E or P/B ratio or the capitalization of a security to be inconsistent with the manager's style or capitalization designation.

To highlight the cost of rigid style adherence, we will investigate the capital gains realization history of several Vanguard index funds. The funds used in this exercise are intended to demonstrate teaching points and not to suggest a recommendation for or against their purchase in the future. Since we are applying information from mutual funds, the costs presented should be considered as the most conservative way to estimate what investors on average are likely to experience. With the exception of redemption activity, the only time stocks in the portfolio are sold is when the index is adjusted, or "reconstituted." There is another event that can cause a taxable transaction: the merger of two firms conducted on a cash basis, versus an exchange of shares. Therefore, the costs involved are in most cases far lower than would be the case if active managers were employed. Mutual fund capital gains generation information is taken from Morningstar Principia to highlight how easily this type of analysis can be done.<sup>4</sup>

First, we will examine the impact that adherence to market capitalization parameters has on generating capital gains and taxes. The challenge occurs when the sponsor reconstitutes the indices and eliminates the most successful stocks in small- and mid-cap portfolios. To maintain the integrity of the index portfolio, the manager sells stocks, which usually results in substantial gains. When small- and mid-cap stocks rise rapidly in capitalization, as with technology issues during the latter half of the 1990s, the indices have the potential to produce short-term capital gains that are taxed at the higher rates for ordinary income. This challenge is not a factor with large-cap portfolios, as there is no need to remove a long-term consistent growth stock, such as General Electric. Therefore, we should expect both small- and mid-cap index portfolios to generate meaningful capital gains in order to maintain desired market capitalization criteria. The cost of this phenomenon is shown in **FIGURE 2** using information taken from Morningstar Investment Detail Reports for the Vanguard 500, Mid-Cap, and Small-Cap index funds. All capital gains distributions have been adjusted to reflect a \$100 investment at the beginning of the year.

**FIGURE 2** *Impact of Capitalization on Capital Gains Realization Distribution per \$100 Investment*

VANGUARD FUND/BENCHMARK	1999	2000	2001	2002	2003	AVERAGE
500 Index/S&P 500 Index	\$0.88	\$0.00	\$0.00	\$0.00	\$0.00	\$0.18
Mid-Cap Index/S&P MidCap 400 Index	\$8.71	\$8.68	\$2.05	\$1.10	\$0.00	\$4.11
Small-Cap Index/ Russell 2000 Index	\$9.81	\$12.80	\$0.00	\$0.00	\$0.00	\$4.52

Source: Morningstar, Douglas S. Rogers

**FIGURE 3** *Weighted Blend Capital Gains Realization Versus Total Market Distribution per \$100 Investment*

VANGUARD FUND/BENCHMARK	1999	2000	2001	2002	2003	AVERAGE
70% Large/20% Middle/ 10% Small/S&P500, S&P400 & Russell 2000	\$3.34	\$3.02	\$0.41	\$0.22	\$0.00	\$1.40
100% Total Market Stock Market Index/ Wilshire 5000 Index	\$1.29	\$0.42	\$0.00	\$0.00	\$0.00	\$0.34

Source: Morningstar, Douglas S. Rogers

Five years of information is shown, as the Vanguard Mid-Cap Index Fund began in May 1998. More important, using an average of the five years gives a more accurate portrayal of what to expect in any one year, as the bull market up to the spring of 2000 had a much greater impact on capital gains generation when compared with the bear market that followed. As expected, adherence to market capitalization parameters has a tremendous tax impact with small- and mid-cap index portfolios. From a tax standpoint alone, it is reasonable to lump small and middle capitalization together to create a small/middle-capitalization category. A typical equity allocation—or in this case, a fund allocation—of 70 percent 500 Index, 20 percent Mid-Cap Index, and 10 percent Small-Cap Index with the resulting capital gains is compared with the Vanguard Total Stock

**FIGURE 4** *Impact of Style on Capital Gains  
Realization Distribution per \$100 Investment*

VANGUARD FUND/BENCHMARK	1999	2000	2001	2002	2003	AVERAGE
Value/S&P 500/ Barra Value Index	\$8.71	\$4.28	\$4.29	\$0.00	\$0.00	\$3.45
Growth/S&P 500/ Barra Growth Index	\$3.28	\$0.00	\$0.00	\$0.00	\$0.00	\$0.66
Small-Cap Value/ S&P SmallCap 600/ Barra Value Index	\$5.72	\$5.92	\$5.70	\$2.62	\$0.00	\$3.99
Small-Cap Growth/ S&P SmallCap 600/ Barra Growth Index	\$0.00	\$5.01	\$0.00	\$0.00	\$0.00	\$1.00

Source: Morningstar, Douglas S. Rogers

Market Index Fund, which attempts to replicate the overall domestic equity market (see **FIGURE 3**).

The capital gains distribution of the traditional blend that consultants and advisers for tax-exempt accounts use to construct client portfolios results in more than four times the amount of capital gains generation that holding the market portfolio, as represented by the Vanguard Total Stock Market Index Fund! It should be noted that the two examples represent a best-case scenario, because the primary source of capital gains realization is from trading activity conducted as a result of reconstituting the underlying index of the funds. With active management, the comparative results would most likely be far more dramatic, since managers would have additional trading activity when selling less attractive stocks for those they believe will offer superior returns in the future.

The second factor pertains to the trading activity required to maintain a particular buy-and-sell stock methodology or style that results in undesirable capital gains and taxes. In the following example, we will analyze results from Vanguard's value and growth style index funds (see **FIGURE 4**).

Caution should be taken in comparing the results of the style indices by capitalization, because the large-cap funds (1992) were created six years before the small-cap series (1998). Therefore, they had more time to accumulate an unrealized capital gain position. However, what the funds do show is that buy-and-hold growth is more tax-efficient when measured by

the dollar amount of capital gains generated by a factor of approximately 4 to 1. For this period of analysis, Vanguard employed the index information from S&P 500/Barra, but it has recently switched to a new methodology created by Morgan Stanley Capital International.<sup>5</sup> Barra categorizes stocks as being value or growth according to their relative P/B ratio, as studies have demonstrated that this measure is more stable than the P/E ratio.<sup>6</sup> When indices are reconstituted, stocks sold from a value index portfolio are likely to have appreciated significantly, causing the realization of meaningful dollar amounts of capital gains. From a tax view, even with index funds, the value-stock selection methodology represents more of a trading strategy rather than a buy-and-hold proposition that will allow capital gains to compound tax-free until realized. On the other hand, a stock removed from a growth index is likely to have been experiencing a declining price and may have minimal appreciation, or possibly even be sold at a loss. When losses occur with taxable accounts, or in this example an index fund portfolio, they offer economic value because they will ultimately be used to offset a portion of realized capital gains.

Another factor that has contributed to lower tax efficiency for value-oriented portfolios is that dividends were taxed at the ordinary income rate before 2003.

**FIGURE 5** shows that the value style consistently has a higher payout in

**FIGURE 5** *Income of Style of Benchmark Style Funds  
Distribution per \$100 Investment*

VANGUARD FUND/BENCHMARK	1999	2000	2001	2002	2003	AVERAGE	FEE
Value/S&P 500/ Barra Value Index	\$1.60	\$1.57	\$1.40	\$1.69	\$2.53	\$1.76	\$0.23
Growth/S&P 500/ Barra Growth Index	\$0.73	\$0.33	\$0.62	\$0.87	\$0.90	\$0.69	\$0.23
Small-Cap Value/ S&P SmallCap 600/ Barra Value Index	\$0.80	\$0.95	\$0.73	\$0.87	\$2.35	\$1.14	\$0.27
Small-Cap Growth/ S&P SmallCap 600/ Barra Growth Index	\$0.42	\$0.00	\$0.18	\$0.28	\$0.00	\$0.18	\$0.27

dividends, as expected. Using 2002 as an example, for every \$100 invested, an investor subject to the maximum federal tax rate (38.6 percent) would have paid \$0.65 ( $\$1.69 \times 38.6\%$ ) in taxes for dividends distributed from the Value Index Fund, as compared with \$0.34 ( $\$0.87 \times 38.6\%$ ) for the Growth Index Fund. Many separate account investors cannot offset fees against taxable income when filing their tax return. Therefore, to gain an accurate portrayal of the tax impact of dividends from the information in Figure 5, they need to add back the fee to find the gross dividend yield. So in the last column, the fee or cost per \$100 invested is shown for each Vanguard fund. During this five-year period, the expenses for any of the funds shown did not vary by any more than \$0.01. A separate account mirroring the Vanguard Value Fund would have had a gross yield of \$1.92 ( $\$1.69 + \$0.23$ ). Therefore, for separate accounts holding the index portfolio, the difference in tax payments for the value and growth styles would be \$0.74 ( $\$1.92 \times 38.6\%$ ) and \$0.42 ( $\$1.10 \times 38.6\%$ ), respectively. As you can see, if the fee for separate account management was not substantially lower, the mutual fund format may offer the taxable investor an advantage from a tax standpoint, but the separate account format does have an advantage of protecting investors from the adverse impact of shareholder redemption activity.

Combining the impact of portfolio rebalancing and dividend yield dampens the value style's after-tax returns.<sup>7</sup> Therefore, growth-oriented index portfolios are inherently more tax-efficient than those with a value orientation. An exception to this general rule is corporate accounts, which benefit from the exclusion of 70 percent of their dividend income from taxation. In these cases, stocks that pay higher dividends, like preferreds, may offer superior after-tax returns.

The dilemma with the traditional style matrix can be solved in one of two ways. The first method, for separate accounts, is to employ a structure other than the traditional three-by-three matrix. The second method, which pertains to mutual funds, is to utilize a fund vehicle that is not victimized by capitalization gains generation from periodic reconstitution.

There are several equity allocation models that consultants and investors who manage taxable assets can employ to lessen unnecessary capital gains generation and payment of taxes. First, let's examine modifications to the traditional three-by-three matrix. A logical evolution is the "modified traditional" model. In this model, the core and mid-cap manager positions are eliminated. Additionally, small-cap managers are allowed to hold their winners longer by taking on a small/mid-cap mandate, and large-cap managers are allowed to dip down in market capitalization with perhaps as much 20 percent of assets.

The obvious intention of the modified traditional model is to reduce

capitalization- and style-oriented trading and lessen the drag on after-tax performance. However, for large portfolios where separate account managers are employed, there is an additional benefit. A reduction in the number of separate account managers from perhaps nine to four will most likely lead to lower overall management fees, which is also a form of tax. This process works best with elite tax-aware managers, especially for the large-capitalization value and growth mandates. One procedure the consultant or sponsor can employ while serving as the quarterback of the process is to suggest a transfer of stock that has risen in capitalization from a small/mid-cap manager for an equal dollar amount of cash from a large-cap manager. This assumes that the large-cap manager finds the stock of the company in question to be a purchase or long-term hold candidate and has cash available. The modified traditional model is appropriate for clients who wish to have the opportunity to potentially outperform an index portfolio on an after-tax basis and are not comfortable with a quantitative tax-aware approach to equity management.

A compelling alternative to the modified traditional approach described above is the “all-capitalization/style-specific” model (see **FIGURE 6**). With this model, the portfolio manager is allowed to select stocks according to his particular style (value or growth) from a complete universe of securities, which may be represented, for example, by the Russell 3000 or the Wilshire 5000 stock indices. There are very few active managers that offer all-capitalization value or growth products. With the adoption of the traditional equity allocation model over the past thirty years or so, firms gradually dropped these products and focused on style/capitalization-specific strategies. However, with growing interest in tax-aware investing, all-capitalization/style-specific portfolios are experiencing a renaissance with informed investors and advisers. The

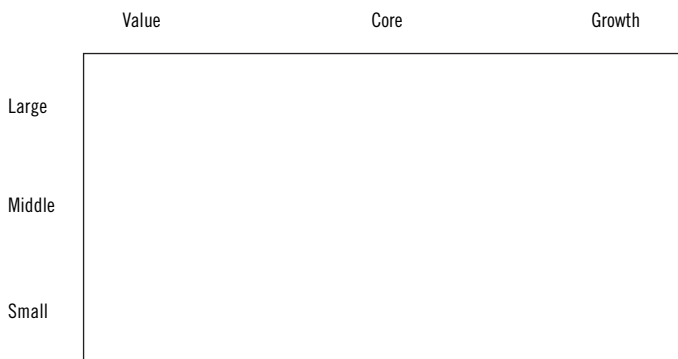
**FIGURE 6** *Modifications to the Traditional 3 x 3 Matrix*

	Modified Traditional			All-Capitalization/Style-Specific		
	Value	Core	Growth	Value	Core	Growth
Large						
Middle						

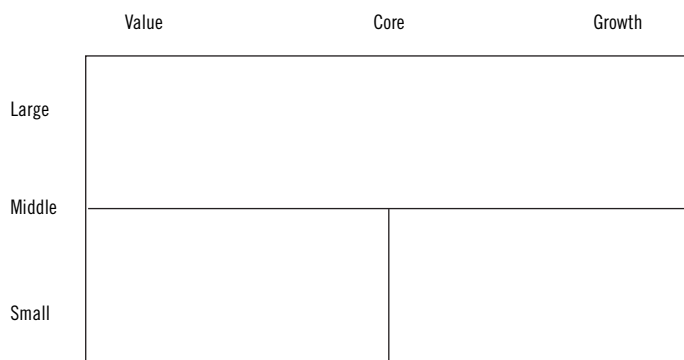
advantage of the all-capitalization/style-specific model is that it allows investment analysts and portfolio managers to take a long-term approach to investing, since they are not forced to sell small- and mid-cap stocks that have had significant appreciation if they still believe it is beneficial to hold them. The worst thing that can happen with the all-capitalization/style-specific model is, for example, if the growth manager sells a company's stock at a short-term loss and the value manager purchases it within thirty days, negating the benefit of the loss sale. It is critical that the consultant or sponsor ensures that timely communication between the two managers is maintained for all trading activity that results in losses. This is often done by facsimile or, even better, by e-mail before the trade being considered is actually executed.

The next type of structure involves using a quantitative tax-aware portfolio strategy or coupling it with less tax-efficient products. These strategies, covered in detail in chapter 10, emphasize constructing a portfolio to replicate the before-tax performance of a designated stock index and then actively trading to generate net losses that can offset gains in other portfolios. It is extremely difficult to manage small portfolios profitably in a tax-aware manner, since taking taxes into account is likely to result in a more labor-intensive process. Thus, the all-capitalization/all-style, or "whole stock" model is especially beneficial for separate account assignments with a total equity allocation from \$500,000 to \$3 million or greater.<sup>8</sup> Perhaps one of the exciting developments on the horizon for taxable accounts is the creation of the all-capitalization/all-style tax-aware global equity portfolio (see **FIGURE 7**).

**FIGURE 7** *All-Capitalization/All-Style Quantitative Tax-Aware Portfolio*



**FIGURE 8** *Combining All-Capitalization/All-Style (Quantitative Tax-Aware Portfolio) With Modified Traditional Portfolio*



Source: Douglas S. Rogers

Astute advisers attempting to maximize after-tax returns use the quantitative tax-aware approach where the odds of outperforming an index are the least attractive and selectively place active managers where they believe they have the potential to produce an alpha of 3.0 percent or better. Therefore, the next logical extension is to combine the quantitative tax-aware approach with small- or small/mid-cap managers, as shown in **FIGURE 8**.

This example represents an S&P 500 quantitative tax-aware core with small/mid-cap value and growth managers, but there are many solutions that are equally attractive. For example, you could have a Russell 1000 quantitative tax-aware core with an actively managed Russell 2000 core small-cap portfolio. Additionally, instead of one or two small- or small/mid-cap managers, you could use three, depending on the amount of assets you are working with and the minimum account size managers are willing to accept. **FIGURE 9**, again from Barclays, shows the percentage of active managers who have underperformed their respective indices on a respective basis. Since closed funds are not included and the data suffer from survivor bias, this picture is more favorable than reality. However, it does show where it makes most sense to make your active management bets.<sup>9</sup>

Also, there can be a separate account for the quantitative tax-aware core and mutual or exchange-traded funds for the small-cap allocation(s). The key here is not to fall into the trap of the tax-exempt industry and drive some preconceived format or number of managers. Be creative and simply

**FIGURE 9** *Percent of Active Managers Underperforming the Index (from 12/31/93 to 12/31/03)*

	VALUE (%)		BLEND (%)		GROWTH (%)	
	BEFORE TAX	AFTER TAX	BEFORE TAX	AFTER TAX	BEFORE TAX	AFTER TAX
Large-Cap	86	98	82	95	67	88
Mid-Cap	71	91	51	89	60	84
Small-Cap	45	81	22	43	18	34

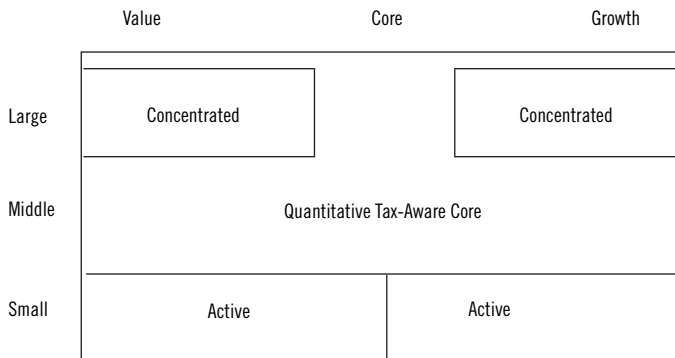
Note: Past performance is no guarantee of future results. All total returns reflect 10-year annualized figures. Funds are categorized by Mornigstar objective.

Source: Barclays Global Investors

do what makes sense with the strategies and products you have available!

Taking this process to the logical extreme results in the “optimal” tax-aware equity allocation model. It is the current rage with tax-aware consultants and advisers today, as it brings together the most compelling features of various types of managers. This model is also known as the “core-and-satellite” or “hub-and-spoke” approach to domestic equity manager positioning (see **FIGURE 10**).<sup>10</sup>

**FIGURE 10** *Optimal Tax-Aware Domestic Equity Manager Allocation*

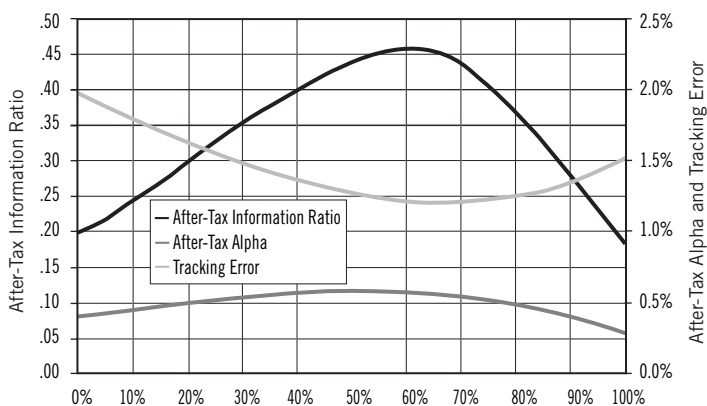


Source: Douglas S. Rogers

In the optimal model, the quantitative tax-aware allocation receives the most significant level of funding and serves as the core or hub, surrounded by satellites or spokes. The satellites or spokes may be small/mid- or small-cap managers or concentrated managers that typically hold twenty or fewer securities. The reduction in nonsystematic or security-specific risk diminishes as stock portfolios hold more than twenty securities.<sup>11</sup> By holding this number of securities or fewer, managers have the best chance of obtaining 3.0 percent plus outsized returns through a select number of ideas they have conviction in. They may hold some of the same securities in the space the core manager occupies. If this is a concern, then core manager can be precluded from purchasing the securities held by the concentrated managers. Additionally, you should not be concerned about the lack of diversification of a concentrated manager, as the core position is already anchoring the overall mix. The concentrated approach can apply to both large- and small-cap allocations, and some firms even include equity long/short hedge funds.

The question for the practitioner is: How many managers should I deploy and what should the allocation to the various components be, especially the quantitative tax-aware core? The allocations to the large- and small/mid-capitalization equity components can be determined through the normal asset allocation optimization process using after-tax assumptions. The two percentages can then be added together for the overall domestic equity allocation. By adjusting the weights of the core and satel-

**FIGURE 11** *Information Ratio, After-Tax Alpha, and Tracking Error by Allocation to the Tax-Managed Core*



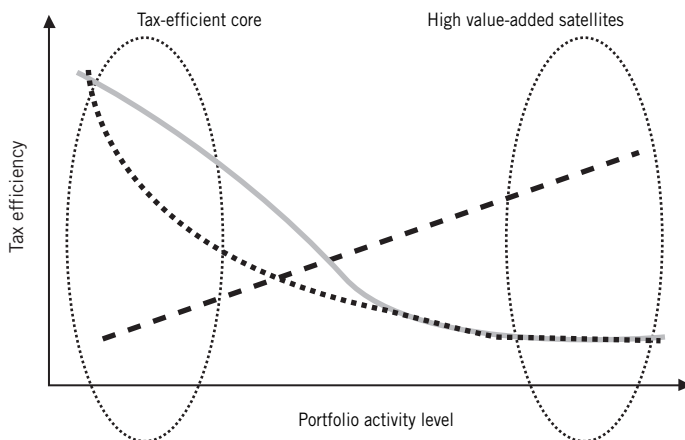
Source: Clifford H. Quisenberry, Jr., "Optimal Allocation of Taxable Core and Satellite Portfolio Structure," *Journal of Wealth Management* (Summer 2003), 18–26.

lite components for a given base-case scenario, Clifford Quisenberry of Parametric Portfolio Associates illustrates in **FIGURE 11** that the after-tax information ratio peaked with approximately 62 percent allocated to the quantitative tax-aware portfolio. In this case, the after-tax information is defined as “the portfolio’s after-tax alpha over the tracking error.”<sup>12</sup>

Applying the information in the figure suggests allocating approximately 60 percent to the core and 10 percent each to two satellites and two small/mid- or small-capitalization managers would produce an attractive portfolio mix to deliver compelling after-tax results that adequately represents each of the nine style boxes. Thus, the mix of managers and funds can easily be done with five or fewer managers. In some cases, there may not be a substantial fee savings, as concentrated and high-alpha managers typically charge 1 percent or more and may even apply the typical 1 percent of fees and 20 percent of profit performance typical of hedge funds. However, the net result should create the potential for much higher returns after all fees and taxes. The graph created by Parametric illustrates one approach to determining the optimal percentage for the core allocation. Consultants and advisers may wish to create their own proprietary method to demonstrate their firm’s distinctive competence.

The key to developing a high-performing mix of domestic equity managers on an after-tax basis is what Jean Brunel refers to as avoiding the “murky middle” (see **FIGURE 12**).<sup>13</sup>

**FIGURE 12** *Moving Away From the Murky Middle: A Core-and-Satellite Approach*



The murky middle consists of the vast majority of equity portfolio managers, who simply have little or no chance of outperforming the benchmark on after-tax basis. Therefore, tax-aware practitioners naturally find comfort in allocating to the extremes that consist of a core manager emphasizing the tax-loss harvesting strategy on one end of the range of choices and high-alpha-generating strategies on the other.

The second way investors can reduce the tax drag from adherence to specific domestic equity style-box allocations is to seek an investment vehicle that does not suffer from the reconstitution of the index, as do mutual funds and separate account mandates. Fortunately, exchange-traded funds serve this purpose well, especially those recently developed by Barclays in conjunction with Morningstar.<sup>14</sup> As described in chapter 9 of *Tax-Aware Investment Management*, the in-kind transfer allows exchange-traded funds to minimize the tax impact to investors, and in certain market environments eliminate it altogether. Since most reconstitutions are announced in advance, portfolio managers of exchange-traded funds can begin acquiring shares to ensure an orderly transition of the portfolio to the new allocation. The Morningstar methodology of style/capitalization index construction incorporates the factors listed in **FIGURE 13**.

The reason these are listed here is the nine iShare portfolios or exchange-traded funds are constructed in a way to minimize the problem with overlap. To address the concern with overlap, Morningstar applies a method of control called “ownership zones.” This allows investors to create mixes of portfolios and funds with the confidence that they will not end up with an undesirable percentage allocation to one or more style/capitalization blocks. Moreover, they can do so with the iShares Morningstar funds and indexes in a way that is highly tax-efficient. Additionally, although a

**FIGURE 13** *iShares Morningstar Index Methodology*

VALUE FACTORS		GROWTH FACTORS	
Price/Projected Earnings	50.0%	Long-Term Projected Earnings Growth	50.0%
Price/Book	12.5%	Historical Earnings Growth	12.5%
Price/Sales	12.5%	Sales Growth	12.5%
Price/Cash Flow	12.5%	Cash Flow Growth	12.5%
Dividend Yield	12.5%	Book Value Growth	12.5%

brokerage fee is charged to purchase and sell them, annual fees run from only 0.2 to 0.3 percent annually, depending on the specific product.

The Morningstar iShares index methodology is more in tune with the way the mix of portfolio holdings for taxable investors should be constructed, as compared with the Russell methodology, where approximately 30 percent of large-cap stocks are owned by both the Russell 1000 Value and the Russell 1000 Growth indices. This is fine with pension or charitable accounts portfolios where taxes are not a consideration, as you often find relative value and growth-at-a-reasonable-price (GAARP) style managers holding many of the same stocks. However, taxable accounts should avoid pairing these types of managers, as their trading often violates the thirty-day wash sale rule negating the value of selling a security at a loss, and when you combine the two you typically have little more than an expensive market portfolio. Moreover, high alpha is more often associated with managers that adhere to deep or extreme style emphasis.

The core portion of the “optimal” portfolio does not have to be an index-oriented product to be effective. There are managers who attempt to use the before-tax approach they have mastered for a decade or more and now apply a tax-loss harvesting overlay to their process. Although their before-tax return tracking error will be greater than their index-based peers, this is necessary for them to create a desirable before-tax alpha. If they can successfully achieve both a before-tax alpha driven from security allocation and security selection and an after-tax alpha from tax-loss harvesting, the investor is the ultimate beneficiary. Family offices are using this type of approach to highlight that what they offer is unique in the marketplace and really allows their managers to focus on long-term results, rather than being subject to the ridiculous pressures of the tax-exempt consulting community which wants them to pigeonhole them in one of the nine style/capitalization boxes. Moreover, this type of approach and tax-efficient exchange-traded funds can allow the manager to migrate to or overweight the portions of the matrix they feel have the opportunity for superior long-term returns based on valuation. For example, Don Phillips of Morningstar related at a Barclays iShares conference that as of the fall of 2004, small-cap value has outperformed large-cap growth over the past five years by perhaps the widest margin in the modern history of the markets.<sup>15</sup> This outperformance will not last forever. Therefore, if you accept a contrarian’s approach, the all-capitalization-and-style tax-aware manager can gradually shift his portfolio style and capitalization to areas with the greatest return potential. Another alternative is using Morningstar iShares, since they are extremely pure in style and capitalization, allowing the adviser to use a minimal amount of dollars to achieve the desired allocation. This is the type of tactical

redeployment of assets that can be executed in a tax-aware manner based on sound principles and judgment.

In summary, efficiently allocating equity managers for taxable accounts initially appears to be a more complex process than with retirement plans or eleemosynary organizations where taxes are not a factor. However, with experience, it becomes a simple and natural process of doing what is necessary to achieve the highest after-tax return possible. By taking into account the following factors, taxable investors benefit by adopting innovative equity allocation models that suit their client's needs:

- ❑ Establishing the total dollar amount of the equity allocation
- ❑ Reducing the number of equity managers employed to minimize unnecessary capital gains and taxes by adopting an allocation model other than the three-by-three matrix developed for tax-exempt accounts
- ❑ Positioning a quantitative or traditional manager with a focus on tax-loss harvesting in the core position
- ❑ Deploying traditional managers where they have the greatest probability to succeed
- ❑ Emphasizing concentrated or high-alpha-generating portfolios, especially in efficient market niches

Elite practitioners are embracing and will continue to refine and offer innovative tax-aware equity allocation models, because they represent an area of the investment management process that truly has the capability of enhancing the taxable client's ultimate wealth.

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### *Chapter Notes*

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1. Much of the discussion on tax-aware equity manager allocation has been taken directly or summarized from Douglas S. Rogers, "Tax-Aware Equity Manager Allocation: A Practitioner's Perspective," *Journal of Wealth Management* (Winter 2001): 39–45.
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8. R. M. Ennis, "The Case for Whole Stock Portfolios," *Journal of Portfolio Management* (Spring 2001): 17–26.
9. Barclays Global Investors, The Basics of iShares, marketing document, March 2004.
10. Jean L. P. Brunel, "Asset Location: Case Study of a Critical Variable," Investment Counseling for Private Clients III, AIMR Conference Proceedings, 2001, 18-27; Jean L. P. Brunel, "A Tax-Efficient Portfolio Construction Model," *Journal of Wealth Management* vol. 4, no. 2 (Fall 2001): 43–49.
11. E. J. Elton and M. J. Gruber, *Modern Portfolio Theory and Investment Analysis*, 3rd ed. (New York: John Wiley, 1987).
12. Clifford H. Quisenberry, Jr., "Optimal Allocation of Taxable Core and Satellite Portfolio Structure," *Journal of Wealth Management* (Summer 2003): 18–26.
13. Jean L. P. Brunel, "A Tax-Efficient Portfolio Construction Model," *Journal of Wealth Management* (Fall 2001, 43-49).
14. Barclays Global Investors, iShares Morningstar Summary, marketing document, June 2004.
15. Don Phillips, "The New School of Investing Is Here," presentation at Barclays Global Investors Conference, Chicago, October 14, 2004.



## Practices of Elite Tax-Aware Equity Active Managers

*My father has a great expression: ‘The capital-gains tax has created more millionaires than any other government policy.’ The capital-gains tax tends to make investors hold longer. That is almost always the right decision.*

—CHRIS DAVIS

That statement by Chris Davis has more truth than most investors would like to admit. There are times when the best thing the investor can do to maximize after-tax returns is simply not to sell positions with substantial unrealized capital gains. **FIGURE 1**, by Parametric Portfolio Associates, highlights the future performance the manager or investor must achieve to break even and overcome the embedded capital gain hurdle.<sup>1</sup>

The table shows the additional return the manager must achieve, depending on the percentage of cost relative to the market value of the security that will be sold and over what time period in years. This additional return is what all managers strive for and is known as their alpha. For example, if a manager plans to sell a security where the cost basis is 50 percent of the market value, it would require a pretax alpha, or additional annual return, of 3.5 percent for three years just to cover paying the taxes on the sale to break even. This table was prepared before the tax on long-term capital gains was lowered from 20 percent to 15 percent, but the message is clear. Managing portfolios without considering gains realization makes it extremely difficult for low-alpha-generating strategies to be competitive on an after-tax basis. Unfortunately, there are few active managers who incorporate this type of analysis with each buy and sell decision for their taxable investors.

**FIGURE 1** *Tax Alpha Required (Per Year for Holding Time to Justify a Sale at Given Cost Basis)*

	COST BASIS				
	0	10%	20%	30%	40%
1 Yr	24.4	21.5	18.6	15.9	13.3
2 Yrs	11.6	10.2	8.9	7.7	6.5
3 Yrs	7.6	6.7	5.9	5.1	4.3
4 Yrs	5.7	5.0	4.4	3.8	3.2
5 Yrs	4.5	4.0	3.5	3.0	2.5

Active portfolio management can outperform passive investing on an after-tax basis, but it is an extremely low-probability bet when relying on traditional methods. At this juncture, nontraditional methods are those that incorporate the impact of taxes in the portfolio construction process and trading practices that are not part of the tax-exempt account industry. The hope is that these tax-aware methods will become traditional practices in the years to come, but they are currently only being employed astutely by approximately 2 percent of practitioners in 2005. It is a belief of the author that managers who employ these tax-aware methods have a greater than 50 percent chance of outperforming passive management on an after-tax basis, which is higher than the success rate of most managers before tax. This is because tax-aware methods have a much higher probability of creating alpha than the traditional methods of sector allocation and security selection.

Impressive after-tax returns that are both long-term and consistent do not happen by chance. Tax-aware investment management is truly an art form that thus far has only been mastered by a small niche of elite tax-aware practitioners.<sup>2</sup> They are the most proactive toward establishing and enhancing their tax management capabilities and the ones most serious about maximizing their after-tax returns. They allocate significant resources toward creating, monitoring, and maintaining their tax-management process, which shows their commitment and willingness to be successful in this area. To facilitate an understanding of what it takes to become an elite manager, we will examine a progressive list of elements. The ten elements may change with revisions to the tax code—for example, the

50%	60%	COST BASIS				100%
		70%	80%	90%	100%	
10.9	8.5	6.2	4.1	2.0	0.0	
5.3	4.2	3.1	2.0	1.0	0.0	
3.5	2.8	2.0	1.3	0.7	0.0	
2.6	2.1	1.5	1.0	0.5	0.0	
2.1	1.6	1.2	0.8	0.4	0.0	

Source: Parametric Portfolio Associates

amount of taxable income in an equity portfolio is not as important now as it was before 2003.

## Elements of the Hierarchy of Tax-Aware Investing

### *(Equity Portfolio Management)*

- 1 Maintaining low turnover
- 2 Extending the holding period beyond a year and monitoring the level of short- versus long-term capital gains
- 3 Adjusting the level of taxable income, when appropriate
- 4 Tax-loss harvesting as an end-of-year drill
- 5 Incorporating tax-lot accounting in decision making
- 6 Applying specific lot identification or high in, first out (HIFO) versus average cost or first in, first out (FIFO) accounting
- 7 Having qualified professionals serve taxable accounts
- 8 Tax-loss harvesting opportunistically throughout the year, with knowledge of the wash sale rule
- 9 Having analysts and portfolio managers who focus only on taxable accounts and incorporate tax implications in each buy and sell decision
- 10 Being committed to after-tax performance standards and reporting

The truly elite practitioners have mastered all ten elements shown above. The following discussion highlights the importance of each.

**1 *Maintaining low turnover:*** This is the first step or element. Low turnover is nice, but in most cases is nothing more than what comes out of the basic security selection process. All too often, it has nothing to do with attempting to enhance the after-tax returns of the portfolio strategy. Moreover, low turnover by itself does not lead to acceptable levels of tax efficiency unless it is kept below 5 percent annually. Many value managers will state their strategy is tax-efficient because they have turnover of 20 percent a year or less. However, as noted in previous chapters, this often results in tax-cost ratios well above 1.5 percent annually.

**2 *Extending the holding period beyond a year and monitoring the level of short- versus long-term capital gains:*** This element is very basic, but it has a meaningful impact on after-tax performance. If a manager can delay selling a security for several days or even a month so that it benefits from the lower tax rate on long-term capital gains, the delay should be encouraged. This type of activity can be monitored internally by use of the accountant's ratio, as discussed in chapter 8 of the full book. Human experience should be brought into play, because if the price is likely to fall more than the amount of the tax benefit, the security should be sold. It is important to remember the process should be oriented to maximizing after-tax returns rather than minimizing the payment of tax dollars.

**3 *Adjusting the level of taxable income, when appropriate:*** With the change in the tax code in 2003, this feature is no longer as important as it was previously, but there are still some situations where it applies. Moreover, the lower rate on qualified dividends is scheduled to be phased out in 2009 unless additional tax legislation is enacted. Equity portfolio managers need to be careful when they purchase shares of real estate investment trusts (REITs) and foreign securities, which may not produce qualified dividends. Since REITs pay a much higher level of income than most other sectors of the market, taxable-account managers should incorporate this differential in their decision-making process. One provision of the tax act of 2003 that must be remembered is that shares must be held sixty days out of the 121-day period that began sixty days before the ex-dividend date for dividends to qualify for the preferential tax treatment.

**4 *Tax-loss harvesting as an end-of-year drill:*** There are three common ways to execute tax-loss harvesting trades. If conducted properly, these trades can add tremendous value. However, as explained below, two of the three methods may yield less than desirable results.

- a. The first method is what is referred to as the "naked" trade. In this case, the manager sells the security or fund and then goes to cash for at least thirty days to avoid violating the wash sale rule. Typically the same security or fund is repurchased at that time. This leaves the

investor unexposed to the desired security, sector, or asset class, thus the term “naked.” This procedure is tantamount to market timing and should be avoided whenever possible. Don’t be surprised if you encounter a situation where the client directs this type of activity and the asset management firm responds with a form by the compliance officer that the client has to sign, relieving the firm of any responsibility for the trade before any losses can be taken. Additionally, once it takes the losses, it will attempt to leave the proceeds in cash. This is a telltale sign the firm is incapable of adequately serving taxable accounts, contrary to their claims in marketing presentations and the like.

b. The second method is known as the “double-down” trade, a phrase from the game of blackjack. A manager employs this tactic when a security drops in price by a meaningful amount and the manager still believes in the fundamental merits of the security. As in blackjack, to execute this trade, a manager doubles the position size by purchasing an amount of shares equal to those presently owned. The manager does this because he expects the security to rebound in price so that the original purchase price can be reached or exceeded. Once this occurs, the original tax lot is sold to avoid paying taxes. This strategy represents more of a value proposition than a tax-management technique. It lacks a tax-management perspective because even if successful, a tax loss is never taken—it only delays a tax payment. Moreover, when the remaining tax lot is sold, the manager incurs a greater tax liability for the client, as the position carries a much lower cost basis than the original position. Although this strategy can be an effective trading strategy, it serves more to increase individual position risk and falls into a “value trap” and only increases the client’s tax liability. This is a favorite tool of value-oriented managers and is a sign they have not given serious consideration to tax efficiency. Like the naked trade, the double-down trade is to be avoided.

c. The preferred method for executing a tax-loss harvesting trade incorporates a “pair-wise” transaction by selling one security and purchasing another that is somewhat similar or correlated. Correlation is measured in many different ways, including but not limited to buying a security in the same sector or industry, with a similar beta, or influenced by similar economic factors. An example of such a trade would be an international manager selling ING Groep, N.V., the world’s largest insurer, for a loss and temporarily replacing it with AXA Group, the world’s second largest insurer. The idea is that a manager is able to realize a loss for tax purposes without losing (in this example) the global insurance exposure. Of course,

no other insurance company stock will be a perfect match, so individual company risk will never be entirely eliminated. There will always be the opportunity cost if ING appreciates on firm-specific news that would not necessarily affect AXA. This trade is much stronger than the two mentioned previously, as it allows the manager to recognize the realized loss, maintain the portfolio's exposure and risk profile, and return to the original security after thirty days. This method of tax-loss harvesting can lead to significant tax alpha with new accounts funded with cash, especially those in a falling market environment. Managers opposed to pair-wise trading may grouse that they cannot find suitable replacement securities. The evolution of exchange-traded funds for major markets, countries, and sectors invalidates this argument. For example, expanding on the previous example with ING, the manager has several other options available through ETFs. Instead of using AXA, which the manager might not like for a particular reason, he could use a Netherlands index fund, MSCI Europe, Australasia, and the Far East (EAFE) fund, or a global financial-sector ETF, depending on what market exposures of ING he is trying to replicate. Some managers will even use open-end mutual funds or options or futures to harvest the tax loss, as they understand this is one area where they can add tremendous value toward after-tax performance.

The tax-loss harvesting trade is paramount to tax-aware investing. If equity managers ignore this basic exercise, they should not be considered for hire, unless they can consistently deliver an alpha of at least 3 percent a year on a before-tax basis.

**5 Incorporating tax-lot accounting in decision making:** Surprisingly, in 2005 you will find some managers and custodians that do not have this capability. Tax-lot accounting is the essential element that enables managers to make trading decisions based on the cost basis or tax lots of individual security holdings. Whenever a manager buys a security, the price of that security is recorded into the portfolio accounting system. If a manager buys the same security in several different lots over time, the system will be able to record the purchase price and date of each transaction. The benefit comes at the time of sale, when the manager can use the tax-lot accounting system to identify the most advantageous tax lot or lots to sell so as to minimize realized gains when conducting a partial sale of the overall position.

**6 Applying specific lot identification or FIFO versus average cost or FIFO accounting:** As Dickson and Shoven advanced as early as 1994, the accounting convention employed has a meaningful influence on after-

tax results. This feature is operational in nature. When it is present, this element is a clear sign a tax-aware culture permeates throughout the firm.

**7 *Having qualified professionals serve taxable accounts:*** The degradation of the account-servicing function is one of the key reasons why tax-aware investing is having difficulty gaining ground. Unfortunately, with the asset management industry changing from a boutique culture to an asset-gathering one, highly qualified servicing positions necessary to maintain a tax-aware relationship have been eliminated in droves. Many relationships have been terminated, because the economics of an asset gatherer are different than those of a boutique firm. Boutique firms typically start with a few entrepreneurs. After a successful start they pay off their initial debt and achieve a comfortable existence. They grow by providing a distinctive service. However, there comes a time when the founders of the firm would like to cash in on their success and typically sell to an asset gatherer, which pays a premium for the highly profitable operation. Unfortunately, only through rapid growth and cost cutting will the acquisition be successful, as it now has a tremendous debt load or an extremely high goal for return on capital. So following the transaction, the service positions are often eliminated or turned into sales or marketing jobs. Now individuals are compensated by gathering assets rather than by satisfying the needs of the relationship. Additionally, often a person from a tax-exempt account background is assigned the relationship. As a result, it is only a matter of time before the taxable client looks elsewhere for service.

The lack of servicing is also a major concern in open-architecture systems, which in some instances are nothing more than glorified wrap situations. While they provide access to an account strategy at a reasonable fee, they do not guarantee a meaningful relationship by a qualified servicing professional. All too often, the open-architecture system is a crutch for minimally qualified sales and servicing professionals who are only capable of presenting prospects and clients with superficial performance records. Open architecture, or access to multiple firms, is a value-added proposition when the servicing function can take the unique circumstances of the client and allocate assets to managers in a tax-aware manner, which is covered in detail in other chapters.

Tax-aware investing is about process first and long-term relationships serviced by knowledgeable individuals, but accomplishing this requires educated and experienced professionals. You know you have a winner when you hear a firm periodically pulls in all its servicing professionals for an internal conference at least annually to hear about the latest in tax, estate, or regulatory issues. Fortunately, there are still firms, both large and small, that are committed to providing their clients with this type of value-added

expertise. The key point here is that firms may have excellent tax-aware products, but they have less value unless qualified individuals can interact with the taxable clients.

**8 *Tax-loss harvesting opportunistically throughout the year, with knowledge of the wash sale rule:*** At this level in the progression of tax-aware elements, we are getting to the point where active management can offer a true value-added proposition above and beyond what can be achieved through passive investing. This can be stated because doing it requires adherence to all the previous elements. Continuous tax-loss harvesting requires a meaningful commitment by the firm in terms of systems technology and trading. Coding of accounts for various features allows this to be done in volume. However, it requires close coordination between the investment, servicing, operational, and perhaps even the compliance functions of the firm.

These managers need to have systems in place to monitor wash sales rules to ensure they do not repurchase a security within thirty days after the sale. IRS Publication 550 states: “You cannot deduct losses when you sell or trade stock of securities at a loss and within 30 days before the sale you:

- Buy substantially identical stock or securities.
- Acquire substantially identical stock or securities in a fully taxable trade, or
- Acquire a contract or option to buy substantially identical stock or securities.”<sup>3</sup>

The question most taxable investors have is, What constitutes a substantially identical security? Unfortunately, the Internal Revenue Service has not provided a precise definition of the term.<sup>4</sup> The tax-exempt fixed income community was one of first niches to apply this trade, and here is how they approach it. We will demonstrate a swap that would be considered an acceptable trade within the industry, using fictitious municipal bonds. At the beginning of 1994, the portfolio holds a New York Sewer municipal bond with a 6.0 percent coupon due May 15, 2014. The bond was purchased at par. As you may recall, there was a general increase in the level of interest rates across the yield curve of approximately 2 percent in 1994. Since the bond has a duration of approximately 10 years, it falls in price by 20 percent. You decide to sell the security to harvest the loss and wish to purchase another bond without causing a major disruption to the characteristics of the portfolio. You notice an Illinois General Obligation municipal bond available for purchase with a 5.0 percent coupon due September 15, 2013. In this example, there are several items that show the bonds are not identical: different issuer, sector or type of credit, coupon, and maturity. The bonds may have similar but not identical expected price movement to changes in interest rates, so you decide to move forward

with the trade. As we discovered over the past five years, there will always be a few individuals who will push the envelope on accounting issues—even the wash sale rule. For example, they will own a mutual fund that replicates the S&P 500 stock index, sell it at a loss, and purchase an ETF that holds the exact same stocks according to the same allocation scheme. While the two vehicles may have somewhat different liquidity characteristics, they have an R-squared (percentage of return explained by another benchmark or security) of almost exactly 1, or 100 percent. In this case, you should not be surprised if someone eventually questions the trade. To be on safe ground when conducting a tax-loss harvesting trade, you should analyze if there is a meaningful amount of capital at risk when you compare the past return patterns of the sale and purchase candidates. If so, then you are probably safe. The three consequences of a wash sale are:

- You are not allowed to claim the loss on your sale.
- Your disallowed loss is added to the basis of the replacement stock.
- Your holding period for the replacement stock includes the holding period of the stock you sold.

Managers who look to harvest trades only at the end of the year are severely limiting the number of available tax-loss harvesting opportunities they can exploit. For instance, if an investment manager conducts all tax-loss harvesting trades at the end of year, he may have missed opportunities in the beginning of the year, as in 2003 when the market dropped and then rebounded. When interviewing firms, it is paramount to understand how often they review accounts for tax-loss harvesting. If it is only done quarterly or so, they will be unable to extract the true naturally occurring additional value created by market volatility.

Not all accounts need or can take advantage of tax-loss harvesting. For example, you may have clients who are in a net operating loss position and therefore have the luxury of needing to harvest gains. In such cases, the tax-loss harvesting engine can be reversed, and you don't have to worry about the wash sale rule. Better yet, when the client gets out of the net operating loss posture, his portfolio will have a cost basis close or equal to the market value of the portfolio and he can easily start taking losses. This is just another example of how knowledge of tax-aware investing—or in this case, “tax-gain harvesting” and the wash sale rule—can benefit the client.

**9 *Having analysts and portfolio managers who focus only on taxable accounts and incorporate tax implications in each buy and sell decision:*** We are now getting to the pinnacle of tax-aware investing for equity managers. These managers and their firms understand that tax-

able-account investing should serve as a distinct separate business unit and they treat it as such. They go the extra distance to model the impact of every potential sale in their investment decisions. In certain situations, the impact of selling securities with large unrealized gains can be significant. As Figure 1 shows, it might take several years or more for the new security (the purchase candidate) to recapture the costs of paying the capital gains tax. These managers address this issue by using optimizers and performing break-even analysis to determine the tax impact of every potential sale. Using assumptions that are often customized to the specifics of each taxable client's portfolio, the manager considers all tax implications before making a sale. What the process entails is:

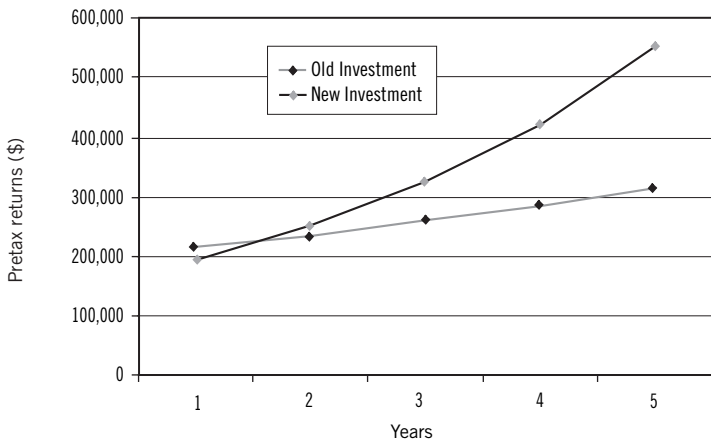
- Calculating the dollar amount of the capital gain that is likely to be realized.
- Determining how much of the price per share of the security considered for purchase must be adjusted upward for the tax impact of the potential sale.
- Recalculating the projected return of the security being considered for purchase with the upward-adjusted price.
- If the projected return of the security being considered for purchase does not clearly exceed the projected return of the security held, calculating a break-even point in years.

If the spread in projected return is still clearly in favor of the buy candidate, follow through with the trade. If not, then human experience comes back into play and you have to ask, "How much conviction do we have in our projected returns?" Some firms take the process a bit further when the projected return of the security being considered for purchase is greater than that of the sell candidate: They calculate a break-even period in years. Then they compare the break-even period with their historical average holding period, which is typically derived from the average turnover rate. If the break-even period is greater than half the average holding period, the trade is withdrawn. For example, if the historical turnover rate of a strategy is 25 percent, the firm assumes an average historical holding period of four years. If the analyst calculates a break-even period of three years for a particular buy candidate, that security would most likely be eliminated from further consideration for the immediate future. Other candidates are considered, or the trade is put on hold until there is a more favorable market environment and the transaction has superior economic value.

A portfolio manager who uses this strategy and has presented the value of its methodology at public conferences is Joanne Howard of Rosenberg Capital Management (RCM).<sup>5</sup> The security break-even analysis by

**FIGURE 2** *Security Break-Even Analysis*

	CURRENT INVESTMENT	NEW INVESTMENT
Company	Xerox	Cisco
Ticker	XRX	CSCO
Shares Owned/To Buy	3,900	2,413
Cost/Share	18.46	
Current Price	46.13	58.00
Current Market Value	179,888	139,970
Capital Gains Tax rate	37%	
Tax \$ Paid	39,918	
After-tax Proceeds	139,970	
<b>Assumptions</b>		
3–5 Year Growth Rate	10.00	30.00
Current Rel. P/E	0.66	1.50
Target Rel. P/E	0.70	1.60
<b>Conclusion:</b>		
YEARS TO BREAK-EVEN	2	



Howard and her associates starts by analyzing the tax cost of selling the existing security (see **FIGURE 2**). In the example, selling Xerox at the current price of \$46.13 will generate a tax cost of \$39,918 on the sale of a position of 3,900 shares. The tax cost is achieved by taking into account the difference in the cost basis and current market value and applying the client's tax rate of 37 percent. Obviously, this is a trade for a position held less than a year and subject to the short-term capital gains tax rate. The reason the trade is being considered is that their analyst believes Cisco has a vastly superior estimated growth rate of 30 percent, as compared with Xerox at 10 percent. However, the trade only makes sense if the current price of Cisco is low enough to overcome the tax bite or cost when Xerox is sold. In this example, the break-even or crossover point is approximately 1.7 years. Most firms that apply this type of analysis believe the break-even point for stock trades needs to be approximately two years or less to justify the trade. This is just one part of the sell decision-making process, but it is an extremely important one that quantifies the impact of taxes. If the analyst or portfolio manager feels strongly the existing holding is likely to fall precipitously in price, then the security should simply be sold. This is not the time to be tax wise and security-outlook foolish! It is this type of methodology that causes many practitioners to call tax-aware investing an art form, rather than an exact science. As simple as this type of analysis is, in the author's experience there are fewer than two dozen firms that employ this type of analysis. Firms focused on serving the needs of their taxable clients are embracing and refining this type of analysis to position themselves as elite tax-aware practitioners.

The challenge with this procedure is you need to have an efficient portfolio accounting system to keep track of the numerous tax lots across all the firm's taxable accounts of the same strategy. This example again demonstrates the value of coupling tax-aware investing concepts with technology.

We will discuss tax-aware fixed income investing in chapter 12 of *Tax-Aware Investment Management*, but Sanford C. Bernstein is one firm that has automated its analysis and trading function to the extent it can quickly determine if a block of bonds it sees offered for sale on the "Street" will add incremental value on an after-tax basis for each and every one of its individual taxable accounts, while taking into account the unique tax profile of each individual relationship. When tax-aware principles are married with technology, the results can be truly impressive. That is why this niche of investing is so exciting today, as we have only encountered the tip of the iceberg in terms of what can be done.

**10 *Being committed to after-tax performance standards and reporting:*** After-tax reporting is simply the icing on the cake. Firms

should attempt to provide individual clients with both pre- and post-liquidation returns, as both offer useful information, depending on the needs of the client. Moreover, if firms have gone to this extreme to position themselves as elite practitioners, they should attempt to brand their report. Examples of a client report by Parametric Portfolio Associates and a sample AIMR-compliant after-tax composite report are given in chapter 7 of the full book.

In years to come, further elements may be added to the list. Beecher Investors has put in place one of the more innovative initiatives. This is a firm that truly endorses tax-aware investing principles, so much so that it has instituted fees based on its after-tax results. If a manager cannot outperform an ETF or tax-managed fund—which are readily available alternatives—on an after-tax basis, then how can it justify charging a fee? It can't, so why shouldn't taxable clients insist on paying for results based on after-tax results? This is an area you will likely hear more about in the future and hopefully will become more common so that it can be added to the list of tax-aware elements in the future.

There are three additional factors managers need to consider in the management of international equity portfolios. The first is that not all foreign stocks produce qualified dividends, and U.S. domiciled accounts and funds are subject to dividend withholding taxes. Second, foreign stocks must be held sixteen days for the investor to claim a credit for the withholding taxes. The third factor involves additional taxes from currency overlay management. If possible, international managers employing currency hedging should be positioned in tax-exempt entities, since the process is inherently tax-inefficient. Unless the manager can demonstrate a meaningful alpha through a methodical process of currency management, taxable accounts are better off emphasizing managers that omit this facet of international or foreign security management.

Another method that is gaining acceptance is managing by taxable client objectives versus tax-exempt consultant demands. In the past, managers were criticized if they did not transition accounts quickly to model portfolios that resulted in minimal return dispersion between accounts. Now taxable-account managers are taking the time to properly analyze the return potential of each security they inherit in conjunction with the cost basis. This is a major change from the mindless process of immediately selling all holdings that do not conform to the new model portfolio, regardless of their cost basis. If the unrealized capital gains are substantial, tax-aware managers may take months or years before eliminating the position and will try to do so when there are losses available to minimize the tax impact. Also, even when starting with cash portfolios, some managers are only funding a

**FIGURE 3** *Before-Fee and Tax Alpha for the Ten Years Ending December 31, 2003*

ASSET CLASS	PERCENTILE RANK FROM "TOP"			N	BENCHMARK
	10%	25%	50%		
Large-Cap Core	<b>3.80</b>	2.01	0.79	129	Russell 1000
Large-Cap Value	<b>3.25</b>	1.78	0.61	191	Russell 1000 Value
Large-Cap Growth	<b>5.29</b>	<b>4.06</b>	2.32	179	Russell 1000 Growth
Small-Cap Value	<b>5.86</b>	<b>3.76</b>	1.59	31	Russell 2000 Value
Small-Cap Growth	<b>11.38</b>	<b>9.64</b>	<b>6.93</b>	116	Russell 2000 Growth
International	<b>6.88</b>	<b>4.11</b>	2.03	227	MSCI EAFE
Municipal Bonds	<b>0.82</b>	<b>0.42</b>	0.17	66	Lehman Brothers Municipal

Source: Plan Sponsor Network, Sean White

portion of their taxable portfolio, as they do not want to subject new clients to rapid trading when some positions are on the cusp as sell candidates and will be eliminated in the months ahead. Each of these practices serves the client's objectives rather than catering to the whims of tax-exempt account consultants. Further insistence by clients and their advisers of managing by client objective will ultimately lead to enhanced wealth creation.

We have discussed the chances that active managers will outperform passive portfolios. To address this issue, we extract alpha-statistic information from the PSN manager database (see **FIGURE 3**).<sup>6</sup>

First, we need to determine the appropriate before-tax and before-fee hurdle for an equity manager to be competitive. We create the hurdle by determining what is required to outperform the appropriate benchmark, that is, the QTA manager's expected return. A QTA manager should outperform the benchmark on an after-tax basis by 1.3 percent per year with normal market volatility and under the current provisions of the tax code. (The outperformance was 1.5 percent under the tax code prior to 2003, when tax rates on ordinary income and capital gains were higher.) Taking into account that the average manager not adhering to tax-aware methods will likely achieve a tax-cost ratio of 1.3 percent, or lose an equal percentage that the tax-loss harvesting firm will gain, results in a return differential due taxes of 2.6 percent (1.3% + 1.3%). The difference in fees, another form of tax, for actively managed separate accounts can vary significantly but is

usually in a range of 0.5 to 1 percent, depending on the asset class and size of the assignment. Using a mid-range of 0.75 percent and a 0.35 percent annual fee for QTA managers creates a fee differential of 0.4 percent. Adding the fee differential of 0.4 percent to the after-tax performance differential of 2.6 percent results in a hurdle of 3.0 percent. Again, this is the alpha, or the amount by which an equity manager needs to outperform a suitable passive benchmark before he should be considered a serious candidate to serve taxable accounts. Readers can adjust the three input variables to accommodate their own outlook for tax efficiency and fees, but this approach makes the search process a simpler task, as it eliminates many firms that simply do not have a process in place to achieve this type of result in the future. As shown for the ten years ending December 31, 2003, managers had to be in the top 10 percent of active core and value managers to outperform the 3.0 percent hurdle, or bogey. The information suggests that managers in less-efficient small-cap and international markets do have a chance to achieve attractive returns on after-tax basis, but is this information representative of the actual experience investors encountered? Unfortunately, manager databases have extreme survivor bias: managers that go out of business or stop submitting data are excluded. Additionally, marketers rarely submit data to a manager database unless the manager's initial performance is at least in the top half of managers. Also, we don't know how many of the managers shown are closed to new business, which is common with small-cap managers. With the exception of small-cap growth, none of the equity classes represented demonstrate a meaningful chance of outperforming on an after-tax basis. For the reasons mentioned, the likelihood that those managers who did outperform the 3.0 percent hurdle, will repeat in the future is far less than the information above suggests.

By applying the nontraditional tax-aware elements discussed above, elite equity managers can in fact achieve compelling after-tax results. As they become more comfortable and competent in the process of executing the elements, they discover a high probability of success. For equity managers, the alternative to a tax-aware portfolio is a concentrated portfolio of twenty securities with greater emphasis on alpha generation. Those who emphasize concentrated portfolios along with the tax-aware elements are being sought out by the most discriminating taxable-account investors and advisers. While elite managers who embrace the tax-aware elements are emerging, they are still in short supply. If taxable investors wish to ensure there are large numbers of managers who can serve their taxable-account needs, they have align themselves with advisers who can identify managers with credible processes and become less dependent on historical records of performance. Furthermore, as Tad Jeffrey suggests, long-term

investors may be better off ignoring the concepts of benchmarking and tracking error and focus on factors more relevant to bottom-line after-tax results.<sup>7</sup> A similar issue that investors must grapple with is the approach of some managers who make large shifts to cash equivalents when they believe opportunities from stocks are less attractive. The action by itself is tax-inefficient, disrupts the overall asset allocation plan, and should be avoided unless the manager can clearly display that over long periods of time he has produced sufficient alpha to justify the process. Hopefully, the emphasis on process and on putting taxable client needs first will ultimately prove that compelling results can be achieved on both a before- and after-tax basis.

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### *Chapter Notes*

1. Parametric Portfolio Associates, “Parametric on Taxes & Investing” (internal marketing presentation), Fall 2001, 2.
2. Much of the discussion on the practices of elite practitioners has been taken directly or summarized from the author’s article with Sean W. Egan, “Evaluating and Classifying Taxable Account Managers,” *Journal of Wealth Management* (Fall 2004):49–62.
3. IRS Publication 550, *Investment Income and Expenses* (2003), <http://www.irs.gov/publications/p550/ch04.html> (accessed November 5, 2004).
4. Fairmark Press Tax Guide for Investors, <http://www.fairmark.com> (accessed November 5, 2004).
5. New York Society of Security Analysts Private Wealth Conference, New York, New York, July 2001.
6. Information compiled by Sean White of CTC Consulting from the PSN (Plan Sponsor Network) database, April 2003.
7. Robert H. Jeffrey, “Tax-Efficient Investing Is Easier Said Than Done,” *Journal of Wealth Management* (Summer 2001): 9–15.

## S U M M A R Y

*There goes another tax-aware investor laughing all the way to the bank!*

—DOUGLAS S. ROGERS

Tax-aware investment management really boils down to mastering four simple steps:

- 1 Utilizing after-tax assumptions in the asset allocation process
- 2 Allocating asset classes and managers/funds according to the characteristics of each entity
- 3 Tax-aware equity manager positioning
- 4 Identifying tax-aware managers/funds

At first, they may seem complicated, but through education and experience any open-minded adviser or investor who desires to capture the opportunity for wealth creation inherent in the process can master them.

While developments of the past decade have significantly enhanced our knowledge of tax-aware investment management, there are still areas that require significant research. These include topics such as determining the precise range for rebalancing target allocations, accounting for unrealized capital gains positions in the after-tax reporting process, and portfolio attribution that includes the impact of taxes on security buy and sell decisions. Solving these challenges requires solutions that might be as radical as tax-aware investment management was only a few decades earlier.

The political winds are certain to change the tax code in the future. While rates may change, deductions may be eliminated, and true simplification may even be adopted, the principles of tax-aware investment management will endure. The key for continued success of tax-aware investment management lies in education and the basic profit motive involved in the process. Education regarding tax-aware investment management will continue to gain momentum, because young degree- and certification-seeking professionals will simply demand it and seek uni-

versities and organizations capable of satisfying their thirst for knowledge. The profit incentive is already in play through portfolio manufacturing, and the spoils will go to those firms capable of delivering systems technology that will provide a clear competitive advantage in the future. Therefore, the knowledge and application of tax-aware investment management is no longer a luxury but a necessity for future success.